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Market Ethos

The latest market insights from the Richardson GMP team

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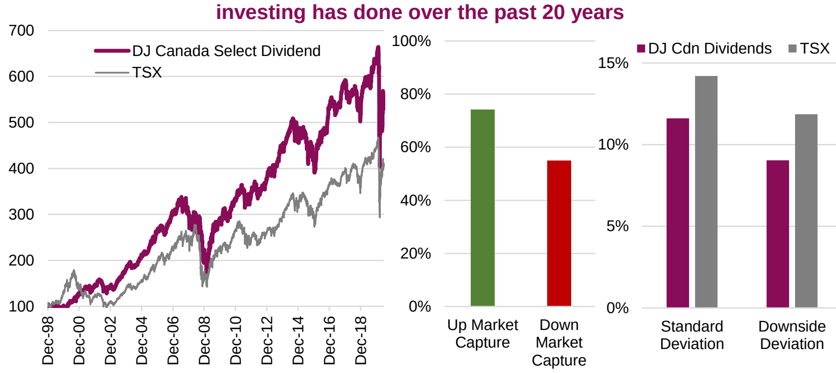
What's wrong with my divs

Craig Basinger, Derek Benedet, Chris Kerlow, Alexander Tjiang

Canadian investors love dividends, perhaps even bordering on a slight obsession. How many investors in, or nearing, retirement plan on leaving the principal intact and just living off the dividends? Many, we would bet. This is one of the reasons there are 693 dividend funds/ETFs (representing $72B) in Canada. In fact, this category is almost as large as the Canadian equity classification, which amount to 831 funds/ETFs ($106B).

There are many perfectly good reasons for this investor affection for dividend investing. Perhaps the biggest is that over the past 20 years, it has been a very strong strategy. **Chart 1** portrays some compelling evidence. Dividends, as measured by the Dow Jones Canada Select Dividend Index, have outperformed the broader market, with less volatility and less participation in downdrafts, and have clearly provided a smoother ride to a higher wealth level. Annualized performance over this period was 8.1% compared to 6.8% for the TSX. OK, so up-market capture is below the market a bit, but down-market capture is way below. This means that in a strong bull market, dividend strategies trail but hold up much better when things go down. Standard deviation and downside deviation both point to lower volatility for dividend strategies. Who wouldn't be sold? And let's not forget, 20 years is more than enough time to hardwire investors to recognize any superior strategy.

Chart 1: Some very strong evidence of how well dividend investing has done over the past 20 years



In the U.S. equity market, dividends have also demonstrated superior risk/return metrics over this period, albeit not to the same degree. The DJ US Select dividend index has enjoyed roughly the same performance as the broader S&P 500, with less downmarket capture and less volatility.

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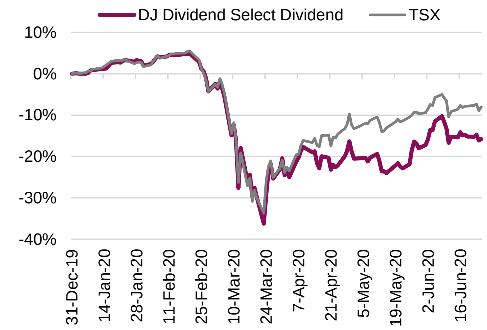
One of the differences between the U.S. and Canadian market is the breadth of companies. The U.S. market has many more quality growth companies that don't pay or have small dividend yields. Canada has much fewer. This has clearly contributed to Canadian investors' increased focus on dividends amid a lack of alternatives. TSX companies that don't pay dividends are dominated by resource and more speculative companies, a clear lack of quality growth companies compared to the U.S. There is also the memory of non or low paying dividend growth companies that soared high only to fall hard – Valeant, Nortel, Blackberry, marijuana stocks.

Chart 2: dividend, min vol and other strategies that have held up better in down markets failed to do so in 2020

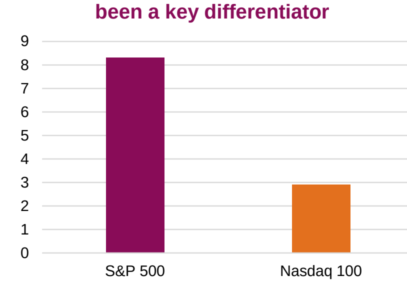


So what went wrong in 2020?

The bear market of 2020 and subsequent bounce off the bottom has clearly separated winners and losers. What surprised many investors during this volatile period was that **dividend strategies did not hold up any better than the general market**. Dividend strategies followed the market down just as fast – a stark departure from many of the past periods of market weakness. To make matters worse, the recovery off the bottom has seen dividend-tilted strategies lag the market (**Chart 2**).

All bear markets and corrections are different, including the current one. One of the big differentiating factors in this market has been financial leverage. Companies with greater leverage, either on their balance sheet in terms of the capital structure or from an operational leverage perspective, have really underperformed. In contrast, those with limited debt, more cash and greater variable cost structures have performed very well. Consider why the Nasdaq is up 9% this year, the S&P 500 is down 7% and the TSX is down 11%. Financial leverage tells a big portion of this tale.

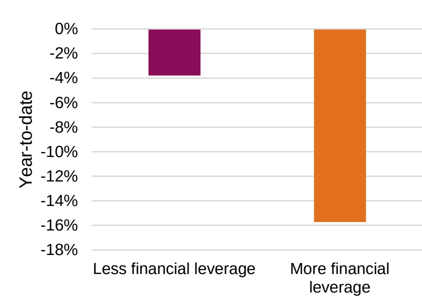
Chart 3: Financial Leverage has been a key differentiator



There are many Nasdaq-listed stocks benefitting from the change in behaviour among consumers and businesses during this pandemic – among them are companies providing online shopping platforms, those spearheading technology that advances remote working, biotech firms, etc. But it is not just those. Companies with considerable financial flexibility have been holding up much better than those that don't. This can be seen in the relative financial leverage score for the S&P 500 consitutuents, compared to the Nasdaq (**Chart 3**).

In Canada, the story is similar. We split the index members between those with greater financial leverage and those with lower financial leverage. Average year-to-date performance for each group has those with more financial leverage feeling most of the pain (**Chart 4**).

Chart 4: In Canada, companies with less financial leverage have handled 2020 much better



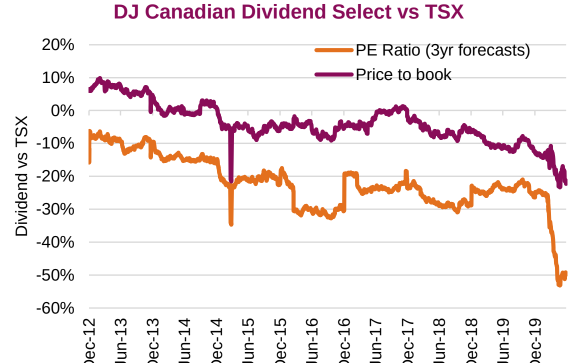
Dividend investing for the 2020s

Don't let one bad bear market for dividends have you throwing in the towel on the strategy. Receiving a steady flow of equity dividends can really help portfolio cash flow, especially considering the limited cash flow from many bonds these days. Add some preferential tax treatment too. Dividend strategies do enjoy lower volatility over the long term, in part thanks to receiving more of your money back earlier in the investment. **And we believe dividend-focused companies should remain the core of investor portfolios.**

A few considerations (including some "pro" and some "con"):

- Today, many dividend-paying companies are inexpensive, which is compelling (**Chart 5**). While the market may continue to reward those companies with less leverage or debt, this will pass.

Chart 5: Dividends are trading at a big discount DJ Canadian Dividend Select vs TSX



- Dividend investing benefits from falling yields, which has been a long trend over the past 30 years. This has benefited some dividend payers more than others: Utilities and telcos benefited greatly; banks are in the middle; and Lifeco and more economically cyclical companies are at the other end of the spectrum. Ensuring a balanced exposure across the spectrum is ideal, especially if we start to see rising bond yields in the decade ahead.
- Get over the aversion to selling some principal. Complementing a core dividend portfolio with some growth or international exposure may reduce your portfolio's dividend yield, but it can have great growth and diversification benefits in the longer term. In addition, you can own something and sell 4% of it each year – presto, you have cash flow. Focusing solely on dividends can lead to a poorly diversified portfolio.

Source: All charts are sourced to Bloomberg L.P. and Richardson GMP unless otherwise stated.